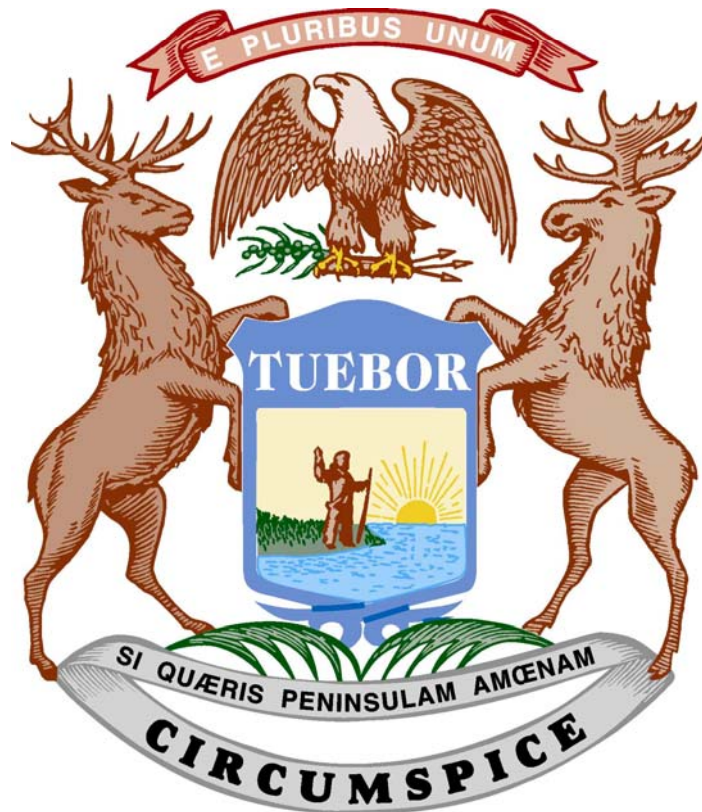


Administration Estimates Michigan Economic and Revenue Outlook



FY 2005-06 and FY 2006-07

**Michigan Department of Treasury
Jay Rising, State Treasurer**

**Economic and Revenue Forecasting Division
Jeff Guilfoyle, Director
Thomas Patchak-Schuster, Senior Economist
Andrew Lockwood, Economist
January 12, 2006**

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ADMINISTRATION ESTIMATES
EXECUTIVE SUMMARY
January 12, 2006

Revenue Review and Outlook

- FY 2005 General Fund-General Purpose (GF-GP) revenue increased to \$8,280.5 million, a 3.0 percent increase over FY 2004. This total is \$255.9 million above the August 2005 Consensus estimate. One-time revenues, including unusually large estate tax payments, accounted for a large part of the increased revenue. School Aid Fund (SAF) revenue rose 2.8 percent to \$10,909.7 million. SAF revenues were \$71.4 million above the August 2005 Consensus estimate.
- FY 2006 GF-GP revenue is projected to decline 1.4 percent to \$8,161.7 million. This total is \$18.1 million above the August 2005 Consensus estimate. SAF revenue is projected to increase 2.9 percent to \$11,221.3 million, \$14.8 million less than the August 2005 Consensus estimate. The January revenue estimates include some revenue items that were not included in the August Consensus estimates. The August Consensus estimates have been adjusted to make them directly comparable to January's administration estimates.
- FY 2007 GF-GP revenue is forecast to increase 3.3 percent to \$8,428.2 million. This total represents a \$266.5 million increase over the FY 2006 administration estimates. FY 2007 SAF revenue is forecast to grow 3.8 percent to \$11,642.3 million. This represents an increase of \$421.0 million over the FY 2006 administration estimates.

2006 and 2007 U.S. Economic Outlook

- Real gross domestic product growth is forecast to average 3.4 percent in 2006 and 2.9 percent in 2007, following 3.6 percent growth in 2005.
- Employment is projected to continue growing over the forecast horizon. The U.S. unemployment rate is forecast to average 4.7 percent in both 2006 and 2007.
- Historically low interest rates, increasingly creative financing arrangements, along with higher home prices, have provided consumers with the ability to purchase housing at historically high levels, refinance existing mortgages, and withdraw substantial mortgage equity. However, with wage and commodity price pressures building, interest rates are projected to increase through the end of 2006.
- Light vehicle sales are forecast to be 17.0 million units in 2006 and 17.1 million units in 2007.
- Consumer price inflation is forecast to average 2.5 percent in 2006 and 2.2 percent in 2007.

2006 and 2007 Michigan Economic Outlook

- In 2006, Michigan wage and salary employment is forecast to fall 0.2 percent and rise 0.3 percent in 2007.
- The Michigan unemployment rate is forecast to remain at the 2005 rate of 6.8 percent for 2006 and 2007.
- Wage and salaries income is forecast to increase 3.0 percent in CY 2006 and 3.7 percent in CY 2007. Personal income will post solid increases throughout the forecast horizon. In 2006 and 2007, personal income is forecast to rise 4.8 percent and 5.0 percent, respectively.
- In FY 2006 and FY 2007, Michigan wage and salaries income is expected to grow 2.9 percent and 3.5 percent, respectively. Disposable income is expected to rise 4.1 percent in FY 2006 and 4.9 percent in FY 2007.

Forecast Risks

A major supply disruption, increased demand or heightened geopolitical tensions could raise oil prices well above the baseline forecast projections. This, in turn, would slow domestic demand more than forecasted.

If international confidence in the dollar declines dramatically, the value of the dollar may fall sharply. A plummeting dollar could roil financial markets, severely curtailing both consumption and investment, and thus slow economic growth sharply.

Firms' increased pricing power, increased obsolescence of current capacity, tighter labor markets, higher commodity prices, and rising health care and pension costs may lead to higher inflation than the baseline forecast projects. This higher inflation rate may crimp consumption and investment spending – especially if accompanied by even more aggressive inflation fighting on the part of the Federal Reserve.

A substantial decline in investor confidence in the long-term bond market would sharply decrease bond prices and significantly increase longer-term interest rates (which move in the opposite direction of bond prices). A spike in long-term interest rates would slow the housing sector, a major growth engine in the current economy, as well as consumption and investment growth in general. Thus, much higher long-term rates would severely curtail overall economic growth.

A flattening or an outright decline in home prices would severely slow economic growth. Further, if a national housing bubble does exist and it bursts over the forecast horizon, there is a chance that the U.S. economy could slow severely. Coupled with other risks materializing, such as sharply higher oil prices and a rapidly declining dollar, a collapsing housing market could send the U.S. economy into a recession.

Geopolitical factors remain a forecast risk.

ECONOMIC REVIEW AND OUTLOOK

January 12, 2006

Current U.S. Economic Situation

Summary

The current U.S. economic expansion is now four years old, having begun in November 2001. Over the past two and a half years, the U.S. economy has posted solid growth. The third quarter of 2005 marked the tenth straight quarter in which real gross domestic product (GDP) growth has exceeded 3.0 percent. Real consumption expenditures have grown at a rate faster than 3.0 percent in nine of the past ten quarters. The equipment and software investment growth rate has exceeded 5.0 percent in each of the past ten quarters.

In the third quarter of 2005, real GDP grew at a 4.1 percent rate. “Employee pricing for everyone” incentives boosted light vehicle sales. As a result, durable consumption grew at a 9.3 percent annual rate and overall consumption grew at a 4.1 percent annual rate. Equipment and software investment remained strong with annual growth of 10.6 percent – marking the second straight quarter that this investment category grew faster than 10.0 percent. Exports and imports grew at roughly the same rate. With a sharp increase in defense spending, federal government expenditures rose at a 7.5 percent annual rate; state and local government spending was roughly flat. Inventories declined after being essentially unchanged in the second quarter.

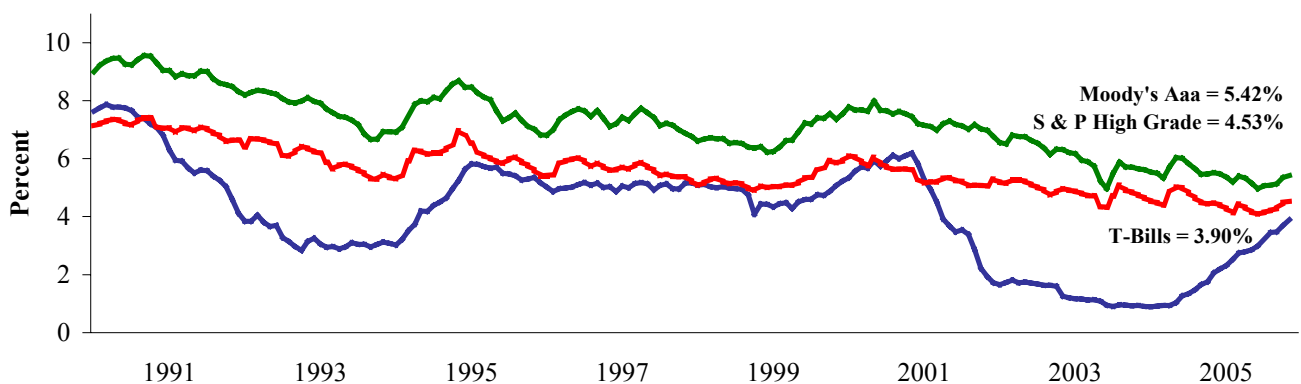
Through the first three quarters of 2005, real GDP has grown at a 3.8 percent annual rate. Consumption has grown at a 3.6 percent pace. Overall investment has increased at a 3.3 percent rate with equipment and software investment rising at a 9.9 percent pace. Federal government spending has risen at a 4.0 percent rate, while state and local government spending has grown at only a 1.5 percent annual pace. Exports have outpaced imports with 6.8 percent and 3.1 percent growth respectively.

Through November, the light vehicle sales rate has averaged 16.8 million units, roughly matching last year’s strong sales pace. Housing starts have averaged a 2.1 million unit rate, the strongest annual performance in over thirty years. Between the third quarter of 2004 and 2005, average housing prices have risen 12.0 percent. Fueled by low mortgage rates, increasingly more creative financing, and speculative buying, the U.S. housing market continues to be strong. In addition, the vibrant housing market has, in turn, supported strong consumption growth and has allowed for a meager or even negative savings rate. As the housing market cools, consumption growth will likely slow as consumers rebuild their savings.

Beginning in June 2004, the Federal Reserve Open Market Committee (FOMC) has increased the target federal funds rate 25 basis points at each of its meetings. At its December 2005 meeting, the Committee raised the target rate for the thirteenth time, increasing the rate to 4.25 percent, the highest federal funds rate in four and a half years. During the 2001 downturn, the FOMC had reduced the federal funds rate to the lowest level in more than 40 years. As the expansion has taken hold, the FOMC has been raising rates to reduce monetary stimulus.

Despite recent FOMC rate hikes, long-term rates have remained low and have actually declined. Compared to June 2004, when the Federal Reserve began increasing the federal funds rate, the three month Treasury bill rate has risen 2.63 percentage points, while the longer term Aaa corporate bond rate has actually fallen by 0.59 percentage points. Increased foreign investment, higher domestic business savings and relatively contained inflationary expectations have helped keep long-term rates low.

Short Term Rates Rising. Long Term Rates Flat.



Source: Economic Indicators.

After falling to \$43 a barrel in December 2004, the average monthly oil price rose to \$66 a barrel in September 2005, in the wake of hurricane Katrina. In November, oil prices fell to \$58 a barrel.

While the increase in oil prices over the course of this year has been significant, natural gas prices have risen much more severely. Hurricane Katrina significantly impaired natural gas production in the Gulf Region. As of early December, approximately 30.0 percent of Gulf Coast natural gas production remained off line. As a result of lost production, natural gas prices have soared. Compared to a year ago, natural gas prices are 86.0 percent higher (three-month moving average). A colder than average winter could spur still greater price increases.

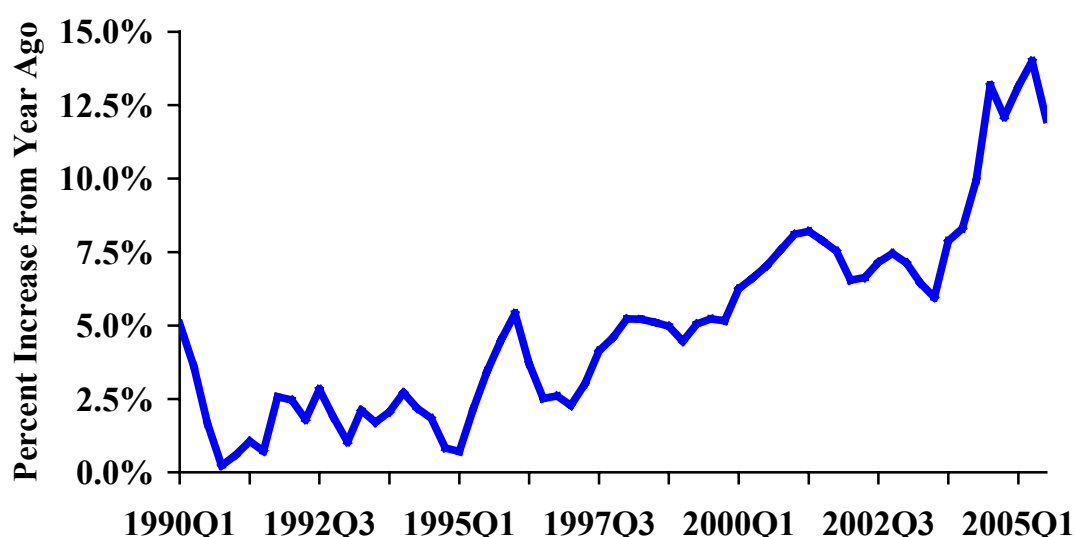
Reports indicate that inflation has remained relatively well contained. In the November 2005 Beige Book, the Federal Reserve reported, “modest overall upward pressures on wages” and “increasing input prices.” Consumer prices however “remained stable” or “experienced [only] modest increases.” In the third quarter, unit labor costs declined, for the second straight quarter, as productivity soared. From a year ago, the November ISM manufacturing prices index was unchanged while the non-manufacturing prices index was up only slightly.

Tighter labor markets and higher energy prices will continue to exert upward pressure on inflation. Recent reports on hourly earnings provide one indication of these pressures. While decelerating in November, average hourly earnings had risen sharply in October. As a result, in November, average hourly earnings were up 3.2 percent from a year ago, the largest yearly increase since early 2003. As noted earlier, oil prices are up substantially and natural gas prices have nearly doubled over the past year.

However, there is little evidence that higher energy prices have pushed non-energy inflation higher. Compared to a year ago, overall November consumer prices are up 3.5 percent. However, core prices (excluding food and energy) are up only 2.1 percent. Overall producer prices are up 4.4 percent from a year ago, but core producer prices were up only 1.7 percent from a year ago. The core consumption price deflator rose at only a 1.4 percent annual rate in the third quarter.

The Office of Federal Housing Enterprise Oversight (OFHEO) reported that average U.S. home prices were up 12 percent in the third quarter compared to a year ago. This is down from a record 14 percent year-over-year growth in the second quarter. High housing asset inflation, representing likely excesses in the housing market, may provide the Federal Reserve a reason for continuing to raise interest rates. The Federal Reserve may seek to stem continued rapid price increases in order to avert a more serious problem later. Some have expressed concern that the national housing market (not just isolated housing markets) is already experiencing a housing bubble. A possible collapse in the housing market represents a very serious downside risk to the baseline forecast. Despite strong growth, there are some indications that the housing market is beginning to cool. According to OFHEO's chief economist, "some deceleration can be seen in a number of the faster-appreciating markets. Price momentum in the Pacific and New England states, in particular, has pulled back."

Housing Market Booming. Cooling Slightly.



Source: Office of Federal Housing Enterprise Oversight

Two key factors affect the economy with lags: interest rates and energy prices. Thus, current economic conditions are affected by past interest rates and energy price levels. Lower interest rates in 2004 helped support current economic growth. Conversely, higher interest rates today will serve to slow growth in the near future. Similarly, the current economy is influenced more by (relatively) lower energy prices in 2004 than current energy prices. Higher current energy prices will serve to slow the economy moving forward.

Major Economic Indicators

Major U.S. economic indicators point to continued economic growth. After having risen to its highest reading of the year in September, the manufacturing ISM index has fallen only slightly over the most recent two months. Through November, the non-manufacturing ISM index recorded a reading near or above 60.0 in all but one month in 2005. For about the past two and half years, the manufacturing and non-manufacturing indices have both indicated growth. A reading above 50 indicates a growing sector. According to the ISM semiannual survey, both the manufacturing and non-manufacturing sectors are expected to see strong growth in 2006.

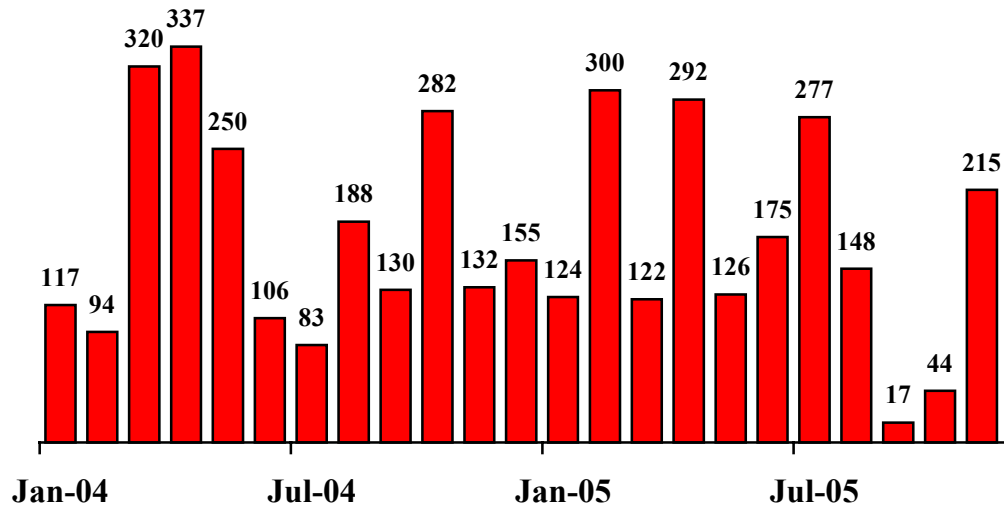
For nearly two and a half years, new orders for durable goods have trended upward. Compared to a year ago, the three-month average of new durable goods orders was up 9.8 percent in November. Excluding volatile defense and aircraft orders, the three-month average of new orders increased 7.4 percent. However, compared to a year ago, the three-month average of industrial production has increased only 2.2 percent – the lowest growth rate in over one and a half years.

In November 2005, the three-month average of retail sales was up 6.3 percent from a year ago. Excluding motor vehicle and gasoline sales, the average increased 7.5 percent – the strongest showing in over a year and a half.

Consumer sentiment fell very sharply in September and declined again in October. As a result, the sentiment index fell to its lowest reading in 13 years. Since October, the index has reported solid gains. Nonetheless, December's sentiment reading remains below the index's mid-year readings. The ABC News/Washington Post consumer comfort index, which measures consumers' attitudes toward current economic conditions, has risen each week over the past five weeks.

Following three months of falling or flat readings, the index of leading economic indicators rose sharply in October and increased again in November.

U.S. Employment Growing (Monthly Change in Thousands)



Source: U.S. Bureau of Labor Statistics

Employment

U.S. employment has increased each month since mid 2003. As a result of hurricane Katrina, employment gains slowed substantially in September and October 2005 but re-accelerated in November. Over the first eleven months of 2005, employment has risen by an average of 167,000 jobs – even with only small gains in September and October. Monthly U.S. employment now exceeds its pre-recession peak by 1.7 million jobs.

However, manufacturing employment remains hard hit. In November, manufacturing employment was 3.4 million jobs (19.1 percent) below its 1998 pre-recession peak. Over the past year, while overall employment has increased, manufacturing employment has declined slightly. Further, November employment in the motor vehicle and parts sector was down 2.3 percent from a year ago. Compared to its 2000 pre-recession peak, motor vehicle and parts employment is down 18.9 percent. Rapid productivity gains allowed firms to reduce payroll employment even as they continued to increase output.

Following the Gulf hurricanes, initial unemployment claims rose above 400,000. However, since October, initial claims have fallen sharply. Compared to a year ago, the four-week moving average of initial unemployment claims has fallen from around 335,000 to around 325,000.

After having indicated contracting employment in May and June, the ISM manufacturing employment index component has signaled expanding sector employment for five straight months. Prior to May, the component had signaled expanding manufacturing employment every month since November 2003. The non-manufacturing ISM employment index has signaled

expansion each month since October 2003. Compared to a year ago, the Challenger report count of announced layoffs fell for the fourth consecutive month in November. In November, the average workweek, a leading indicator for employment, remained unchanged compared to a year ago. The average workweek has remained in the narrow range between 33.6 and 33.8 hours for three years.

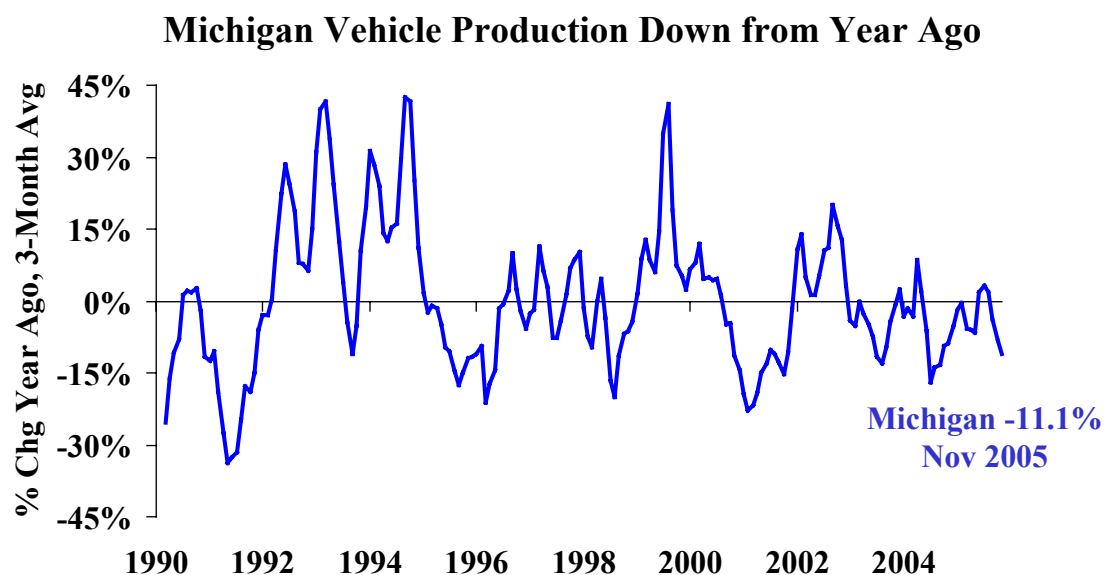
Since May 2005, the U.S. unemployment rate has moved within the narrow range of 4.9 percent to 5.1 percent. Compared to a year ago, November's unemployment rate was 0.4 of a percentage point lower.

Vehicle Sales and Production

Boosted by "employee pricing for everyone" incentives, third quarter light vehicle sales rose to a 17.9 million unit rate, the highest rate since the fourth quarter of 2001. July vehicle sales surged to a 20.7 million unit rate, the highest monthly rate since October 2001. With the end of the employee pricing promotions, sales plummeted to a 14.7 million unit rate in October, the lowest sales rate in over seven years. Sales rebounded in November to a 15.7 million unit pace.

Over the past several years, imports and transplants have continued to increase their market share. Thus, the traditional Big 3 market share has declined sharply over the past 15 years. The Big 3 accounted for 71.6 percent of the U.S. light vehicle market in 1990. In 2005, the Big 3 will account for only an estimated 57.0 percent, a record low.

Through November 2005, Michigan vehicle production is down 4.7 percent, compared to essentially flat production (+0.2 percent) nationally. Averaged over the past three months, Michigan vehicle production is down 11.1 percent, compared to a 2.7 percent increase nationally (three month moving average).



Source: Michigan Department of Treasury and Automotive News.

Current Michigan Economic Conditions

Employment

Michigan's economy relies heavily on the performance of the manufacturing sector in general and the auto industry specifically. Given extremely weak manufacturing employment performance, declining vehicle production, continued declines in Big 3 market share along with continued supply rationalization among vehicle suppliers, Michigan's employment performance has been below the national average. Substantial productivity gains in the vehicle industry have also contributed to Michigan's sub-par employment performance.

From Michigan's employment peak in June 2000 compared to November 2005, Michigan has lost 332,700 jobs. However, employment declines have slowed considerably since December 2002. Since the end of 2002, monthly declines have been slowed by more than half.

Michigan manufacturing employment has declined sharply. Since June 2000, Michigan manufacturing employment has fallen by 234,700 jobs. Michigan has lost one out of every four manufacturing jobs it had at the State's employment peak.

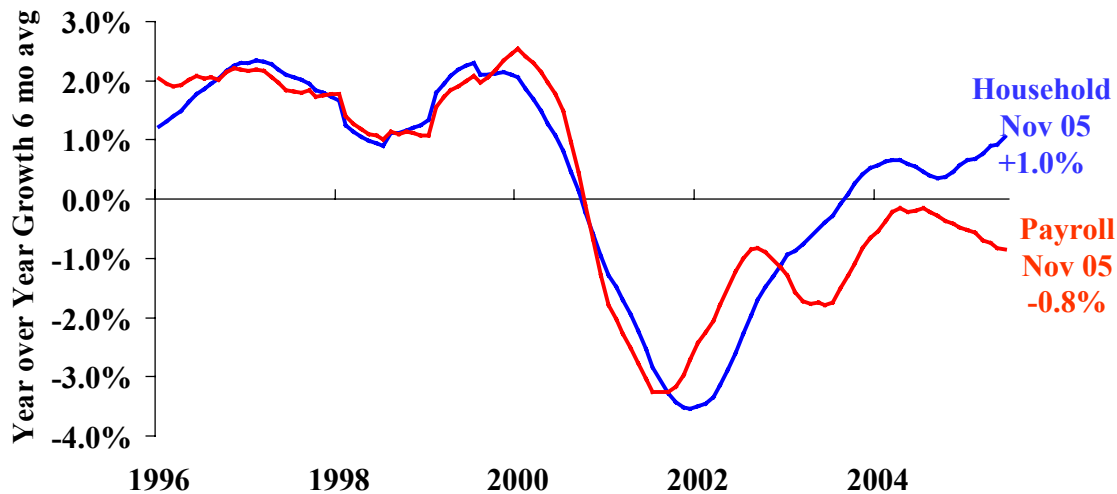
The Bureau of Labor Statistics provides two measures of employment:

1. Household employment data generated from a survey of households (Current Population Survey). Household employment is a count of the number of persons employed.
2. Wage and salary employment data generated from a survey of firms (Current Employment Survey). Wage and salary employment is a count of the number of jobs.

Over the past year, the two measures have diverged and there is now a substantial disparity between the two measures. Michigan wage and salary employment is *down* 0.8 percent, but Michigan household employment is *up* 1.0 percent (six month moving average). While wage and salary employment data is usually considered a better measure, household data often does a better job at detecting turning points than wage and salary data. Given the divergence, the household employment data may be detecting a turning point in Michigan's labor market that the wage and salary employment data has not yet picked up. Revised employment data series will be available in March 2006.

Recently, both employment measures have been encouraging. In three of the past four months, Michigan wage and salary employment has increased as has household employment. In November, household employment increased in all 17 major labor market compared to a year ago.

Employment Surveys Send Mixed Signals



Source: Bureau of Labor Statistics.

Unemployment Rate

Through November, Michigan's 2005 unemployment rate has averaged 6.8 percent. This is down from 7.1 percent reported for both 2003 and 2004. In November, Michigan's unemployment rate was 6.6 percent, down from 7.4 percent a year ago.

Personal Income

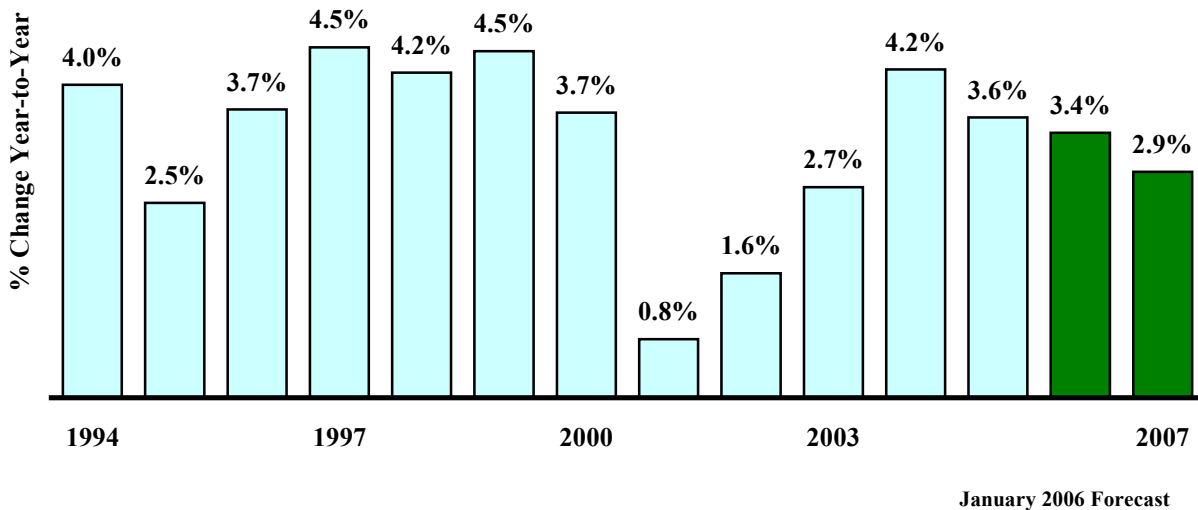
Michigan personal income rose at a 3.3 percent annual rate between 2002 and 2004. Compared to a year ago, third quarter 2005 personal income grew 3.6 percent, compared with 5.6 percent growth nationally. Third quarter Michigan wages and salaries income grew 3.1 percent compared to a year ago, while U.S. wages and salaries income increased 5.9 percent.

2006 and 2007 U.S. Economic Outlook

Summary

Real GDP growth is forecast to slow from 3.6 percent growth in 2005 to 3.4 percent growth in 2006 and 2.9 percent growth in 2007. High consumer debt levels, low savings rates, high energy prices, and higher interest rates are expected to slow growth. On the other hand, increased business investment supported by profits and solid balance sheets should help buoy growth.

GDP Growth Slower in 2006 and 2007



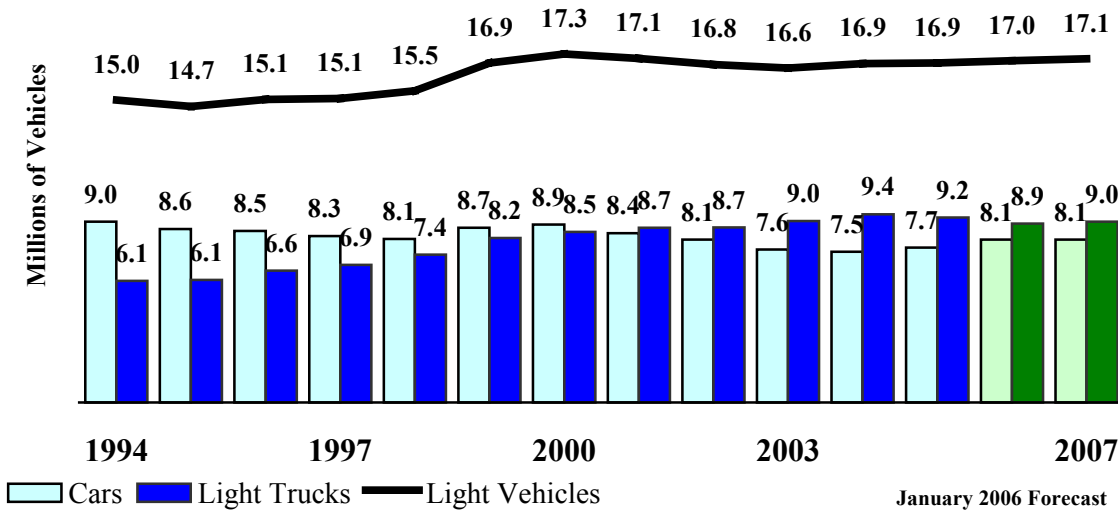
Source: Bureau of Economic Analysis, U.S. Department of Commerce, and Administration Forecast, January 2006.

Light vehicle sales are projected to remain relatively stable with forecasted sales of 17.0 million units in 2006 and 17.1 million units in 2007.

As measured by the consumer price index (CPI), consumer inflation is expected to slow from 3.4 percent in 2005 to 2.5 percent in 2006 and 2.2 percent in 2007. Interest rates are forecast to rise as the Federal Reserve continues to raise the target federal funds rate through the end of 2006. Between 2005 and 2007, the 3-month Treasury bill rate is forecast to increase from 3.2 percent to 5.2 percent while the Aaa corporate bond rate increases from 5.3 percent to 6.4 percent and 7.0 percent in 2006 and 2007 respectively.

U.S. wage and salary employment is forecast to rise in 2006 and 2007 with gains projected throughout the forecast horizon. Employment will increase by 2.1 million jobs in 2006 and 1.9 million jobs in 2007. The U.S. unemployment rate is expected to fall from 5.1 percent in 2005 to 4.7 in both 2006 and 2007.

Motor Vehicle Sales Stable



Source: Bureau of Economic Analysis, U.S. Department of Commerce, and Administration Forecast, January 2006.

Assumptions

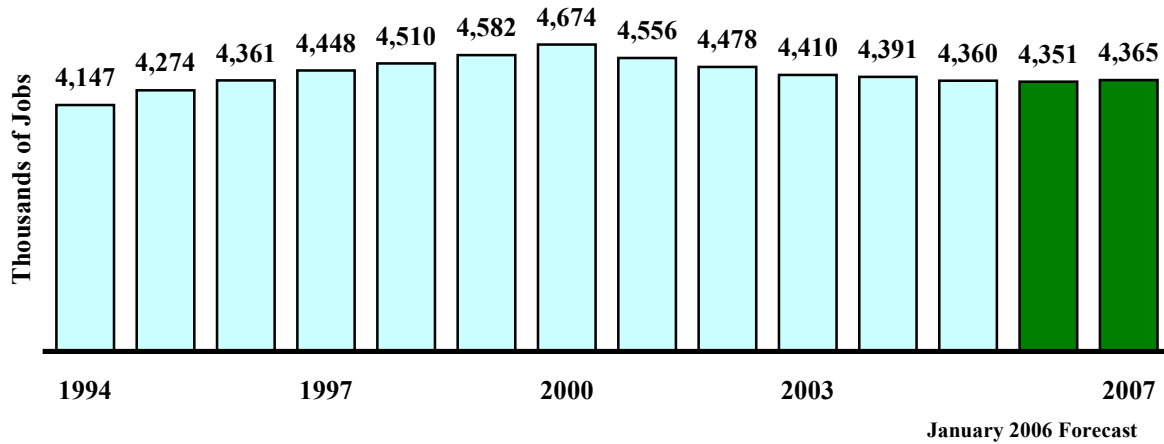
Oil prices are projected to fall to about \$55 a barrel by mid 2007 where they are expected to remain over the balance of the forecast horizon. With continued commodity price pressures and concerns about a frothy housing market, the Federal Reserve is assumed to continue to raise the target federal funds rate through the end of 2006. The target federal funds rate is projected to rise to 5.50 percent by the end of 2006, at which time the Federal Reserve is expected to leave the target rate unchanged over the balance of the forecast horizon.

The household savings rate is forecast to rise to around 1.0 percent by early 2006 and remain within the narrow range of 0.8 percent to 1.8 percent over the forecast period. Home price increases are expected to slow over the forecast and stock market price gains are expected to be modest.

2006 and 2007 Michigan Economic Outlook

Michigan employment is forecast to decline slightly in 2005, marking the fifth straight year in which State employment has declined. Employment is expected to fall, though only slightly (0.2 percent), in 2006. Employment is then expected to rise 0.3 percent in 2007. The Delphi bankruptcy and struggles at the domestic Big 3 automakers will continue to restrain Michigan employment. In general, continued declines in manufacturing employment will constrain overall Michigan employment. Employment is forecast to begin rising in late 2006. In 2007, employment is forecast to increase an average of 5,000 jobs per quarter. Michigan's unemployment rate is expected to remain flat over the forecast period, averaging 6.8 percent each year between 2005 and 2007.

Michigan Wage and Salary Employment



Source: Michigan Department of Labor and Economic Growth, U.S. Bureau of Labor Statistics, and Administration Forecast, January 2006.

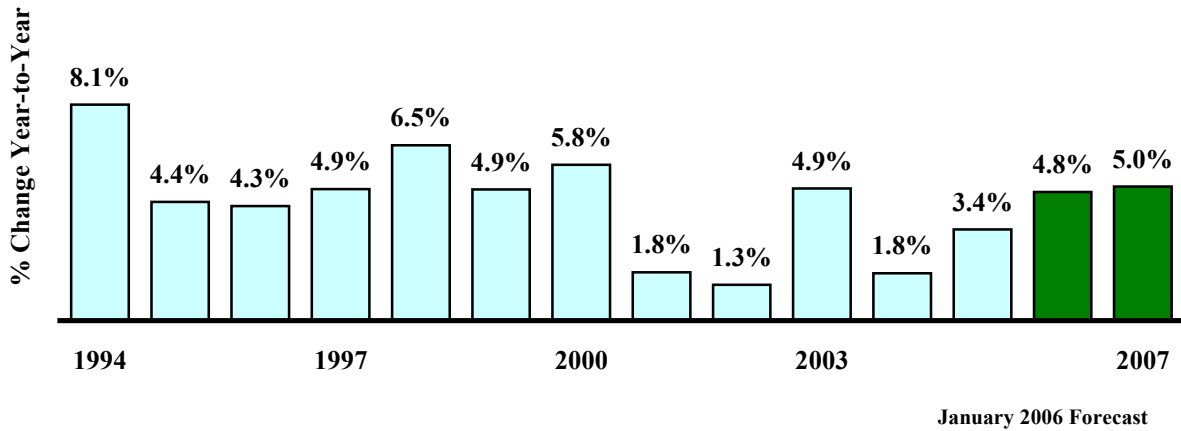
Michigan wage and salaries income is projected to rise 3.0 percent in 2006. In 2007, wage and salaries income is forecast to increase 3.7 percent as employment grows. Michigan personal income is forecast to rise 4.8 percent in 2006 and 5.0 percent in 2007.

Inflation, as measured by the Detroit CPI, is forecast to rise 2.4 percent in 2006 and 2.0 percent in 2007. As a result, real Michigan personal income (inflation adjusted) is expected to rise 2.3 percent in 2006 and 2.9 percent in 2007.

Table 1
Administration Economic Forecast
January 2006

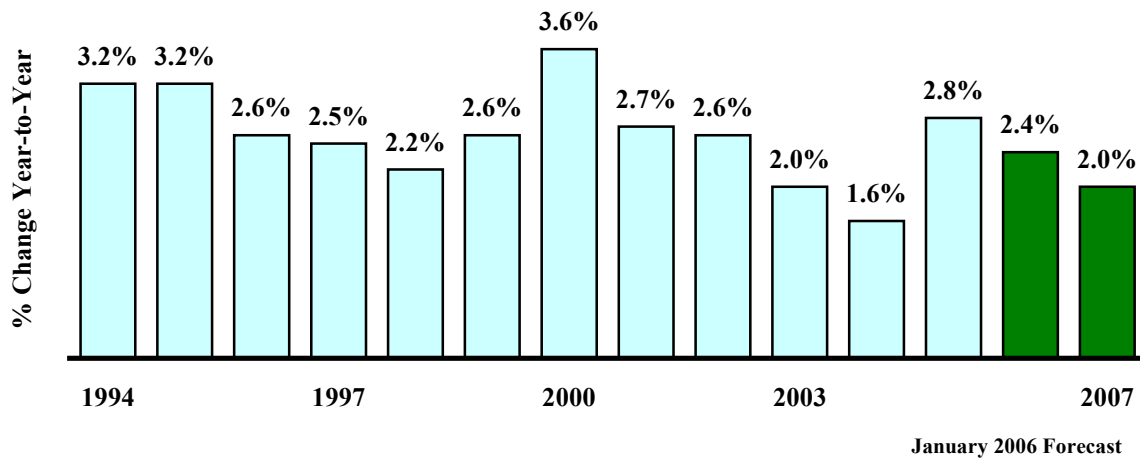
	Calendar 2004 Actual	Calendar 2005 Forecast	Percent Change from Prior Year	Calendar 2006 Forecast	Percent Change from Prior Year	Calendar 2007 Forecast	Percent Change from Prior Year
United States							
Real Gross Domestic Product (Billions of Chained 2000 Dollars)	\$10,756	\$11,143	3.6%	\$11,522	3.4%	\$11,856	2.9%
Implicit Price Deflator GDP (2000 = 100)	109.1	112.2	2.8%	115.6	3.0%	118.8	2.8%
Consumer Price Index (1982-84 = 100)	188.9	195.3	3.4%	200.2	2.5%	204.6	2.2%
Personal Consumption Deflator (2000 = 100)	108.2	111.2	2.8%	113.8	2.3%	116.3	2.2%
3-month Treasury Bills Interest Rate (percent)	1.4	3.2		4.8		5.2	
Aaa Corporate Bonds Interest Rate (percent)	5.6	5.3		6.4		7.0	
Unemployment Rate - Civilian (percent)	5.5	5.1		4.7		4.7	
Light Vehicle Sales (millions of units)	16.9	16.9	0.0%	17.0	0.6%	17.1	0.6%
Passenger Car Sales (millions of units)	7.5	7.7	2.7%	8.1	5.2%	8.1	0.0%
Light Truck Sales (millions of units)	9.4	9.2	-2.1%	8.9	-3.3%	9.0	1.1%
Import Share of Light Vehicles (percent)	20.2	20.2		21.5		21.4	
Michigan							
Wage and Salary Employment (thousands)	4,391	4,360	-0.7%	4,351	-0.2%	4,365	0.3%
Unemployment Rate (percent)	7.1	6.8		6.8		6.8	
Personal Income (millions of dollars)	\$324,134	\$335,155	3.4%	\$351,242	4.8%	\$368,804	5.0%
Real Personal Income (millions of 1982-84 dollars)	\$174,830	\$175,842	0.6%	\$179,939	2.3%	\$185,236	2.9%
Wages and Salaries (millions of dollars)	\$180,245	\$186,734	3.6%	\$192,336	3.0%	\$199,453	3.7%
Detroit Consumer Price Index (1982-84 = 100)	185.4	190.6	2.8%	195.2	2.4%	199.1	2.0%
Detroit CPI Fiscal Year (1982-84 = 100)	184.4	189.0	2.5%	194.3	2.8%	198.0	1.9%

Michigan Personal Income Growth Stronger



Source: Bureau of Economic Analysis, U.S. Department of Commerce, and Administration Forecast, January 2006.

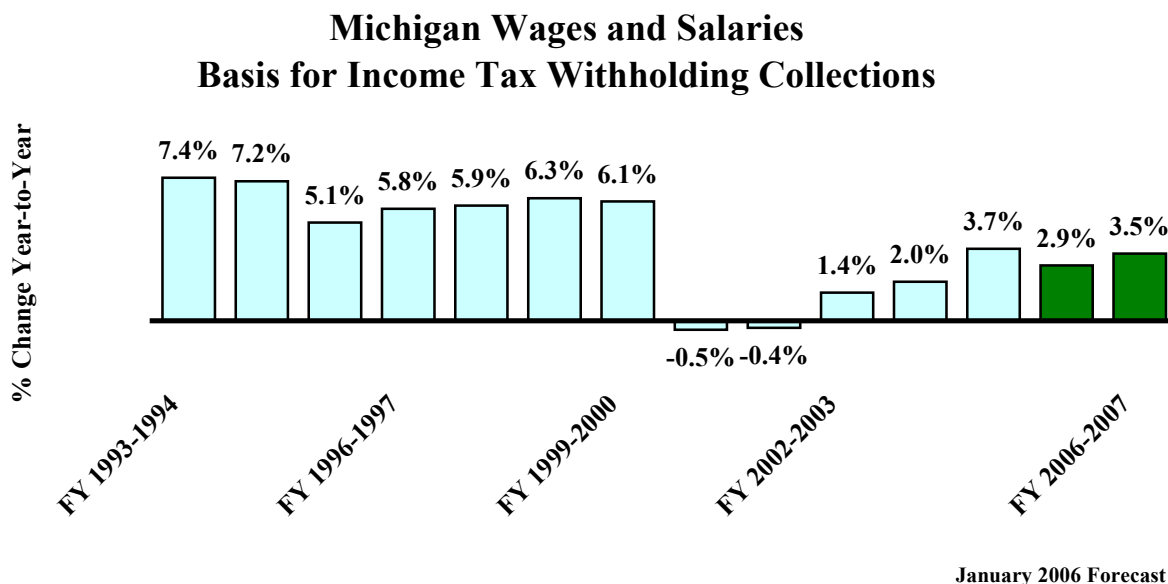
Inflation Rate Slows Detroit CPI



Source: U.S. Bureau of Labor Statistics and Administration Forecast, January 2006.

Fiscal Year Economics

Michigan's largest taxes are the individual income tax (\$6.4 billion), which includes refunds, and sales and use taxes (\$8.5 billion). Income tax withholding is the largest income tax component. Withholding (\$6.8 billion) is most affected by growth in wages and salaries. Michigan wages and salaries are expected to grow 2.9 percent in FY 2006 and 3.5 percent in FY 2007.



Source: Bureau of Economic Analysis, U.S. Department of Commerce, and Administration Forecast, January 2006.

Sales and use taxes depend primarily on Michigan disposable (after tax) income and inflation. Disposable income is expected to rise 4.1 percent in FY 2006 and to increase 4.9 percent in FY 2007. The inflation rate is forecast to rise 2.8 percent in FY 2006 and is expected to increase 1.9 percent in FY 2007.

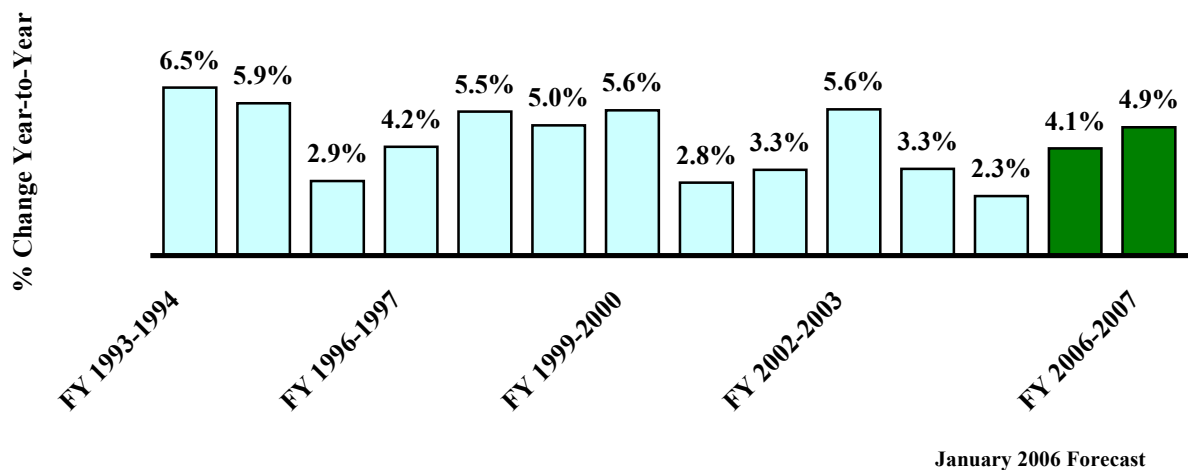
Forecast Risks

The baseline forecast assumes that the price of a barrel of oil will remain in the mid \$50s through most of the forecast horizon. Geopolitical concerns, increased demand or a major supply disruption could raise prices well above this assumed level. At the same time, recent high oil prices may slow the world economy leading to a reduction in the demand for oil and its price. A higher (lower) oil price will help retard/elevate domestic growth.

The baseline forecast assumes that the value of the dollar will fall in an orderly fashion. However, if international confidence in the dollar declines dramatically, the value of the dollar may fall sharply. A plummeting dollar could roil financial markets, severely curtailing both consumption and investment, and thus slow economic growth sharply. A collapsing dollar

would also put upward pressure on inflation and possibly lead to still higher interest rates, which would further retard growth.

Michigan Disposable Income Basis for Sales and Use Tax Collections



Source: Research Seminar in Quantitative Economics, University of Michigan, and Administration Forecast, January 2006.

Firms' increased pricing power, increased obsolescence of current capacity, tighter labor markets, higher commodity prices, and rising health care and pension costs may lead to higher inflation than the baseline forecast projects. This higher inflation rate may crimp consumption and investment spending – especially if accompanied by even more aggressive inflation fighting on the part of the Federal Reserve.

Given Michigan's manufacturing mix, it is very possible that manufacturing growth would grow substantially more slowly than U.S. economic growth itself would imply. This would retard Michigan economic growth, employment and income growth.

If business investment is above projected levels, economic growth may be more than forecast. For the Michigan economy, Big Three market share is important. Sharp declines in market share would affect the Michigan economy adversely compared to other states. Similarly, faster/slower productivity growth may decrease/increase employment. Faster/slower inventory investment will increase/decrease economic growth.

A substantial portion of current U.S. economic activity depends directly or indirectly on the strong housing market. Through refinancings, home equity loans and realization of capital gains on housing sales, rapidly appreciating home prices have provided substantial support for the overall economy. In many ways, consumers have come to rely on appreciating home prices as a source of "income." To the extent to which home prices flatten out, or still more seriously decline, consumption, and in turn investment, may fall more sharply than the baseline forecast assumes.

The baseline forecast assumes that the Federal Reserve succeeds in averting a collapse of the U.S. housing market through federal funds rate increases that translate into increases in higher mortgage rates. To the extent to which the Fed is not successful in effecting an orderly correction in the housing market, a housing bubble may burst and the economy may grow substantially less slowly than the baseline forecast projects. There remains an outside chance that a collapsing housing market, combined with other risk factors, could send the U.S. economy into a recession.

As noted earlier, long-term interest rates have actually declined even in the face of rising short-term interest rates. Interest rates (which move in the opposite direction of bond prices) have remained low because bond prices have remained relatively high. To the extent to which investors regard bonds as less and less attractive investments, bond prices could fall sharply and thus interest rates could rise steeply. A sharp rise in interest rates would adversely impact the housing market, whose strength is greatly dependent upon low mortgage rates.

Geopolitical factors remain a forecast risk.

ADMINISTRATION REVENUE ESTIMATES

January 12, 2006

Revenue Estimate Overview

The revenue estimates presented in this section consist of baseline revenues, revenue adjustments, and net revenues. Baseline revenues provide an estimate of the effects of the economy on tax revenues. For these estimates, FY 2005 is the base year. Any non-economic changes to the taxes occurring in FY 2006 and FY 2007 are not included in the baseline estimates. Non-economic changes are referred to in the tables as "tax adjustments." The net revenue estimates are the baseline revenues adjusted for tax adjustments.

This treatment of revenue is best illustrated with an example. Suppose tax revenues are \$10.0 billion in a given year, and that based on the economic forecast, revenues are expected to grow by 5.0 percent per year. Baseline revenue would be \$10.0 billion in Year 1, \$10.5 billion in Year 2, and \$11.0 billion in Year 3. Assume a rate cut is in place that would reduce revenues by \$100 million in Year 1, \$200 million in Year 2, and \$300 million in Year 3. If Year 1 is the base year, the revenue adjustments for Year 1 would be \$0 since the tax cut for this year is included in the base. The revenue adjustments for Year 2 would be \$100 million, and the revenue adjustments for Year 3 would be \$200 million, since the revenue adjustments are compared to the base year.

In the example above, the baseline revenues would be \$10.0 billion, \$10.5 billion, and \$11.0 billion, for Years 1 through 3, respectively. The revenue adjustments would be \$0 in Year 1, \$100 million in Year 2, and \$200 million in Year 3. The \$200 million in Year 3 represents the tax cuts since Year 1. Net revenue would be \$10.0 billion in Year 1, \$10.4 billion in Year 2, and \$10.8 billion in Year 3.

The following revenue figures are presented on a Consensus basis. Generally speaking, the Consensus estimates do not include certain one-time budget measures, such as withdrawals from the Budget Stabilization Fund, the sale of buildings, etc. The figures also assume the full statutory amount for revenue sharing payments. In addition, the estimates only include enacted legislation and do not include the effects of any proposed changes. The School Aid Fund estimates consist of taxes plus the transfer from the State Lottery Fund.

FY 2005 Revenue Review

FY 2005 GF-GP revenue totaled \$8,280.5 million on a Consensus basis, a 3.0 percent increase over FY 2004. One-time revenue from the estate tax and other one-time revenue items contributed to the increase in General Fund revenue. SAF revenue totaled \$10,909.7 million, a 2.8 percent increase compared to FY 2004 (See Table 2).

Table 2
FY 2004-05 Administration Revenue Estimates
(millions)

	Consensus August 17, 2005		Actual		Change
	Amount	Growth	Amount	Growth	
General Fund - General Purpose					
Baseline Revenue			\$8,035.4		
Tax Cut Adjustments			\$245.1		
Net Resources	\$8,024.6	-0.2%	\$8,280.5	3.0%	\$255.9
School Aid Fund					
Baseline Revenue			\$10,881.7		
Tax Cut Adjustments			\$28.0		
Net Resources	\$10,838.3	2.1%	\$10,909.7	2.8%	\$71.4
Combined					
Baseline Revenue			\$18,917.1		
Tax Cut Adjustments			\$273.1		
Net Resources	\$18,862.9	1.1%	\$19,190.1	2.9%	\$327.2

Prepared By: Economic and Revenue Forecasting Division, Michigan Department of Treasury

FY 2006 Revenue Outlook

FY 2006 GF-GP revenue is expected to be \$8,161.7 million, a 2.5 percent baseline increase, and a 1.4 percent reduction after tax adjustments. Net GF-GP growth is slowed by a number of factors including the newly enacted single business tax cuts and the continued phase-out of the state's estate tax. The FY 2006 estimate is \$18.1 million above the August 2005 Consensus estimate, if the effects of the newly enacted tax cuts are excluded. The cost of tax cuts is \$104 million for FY 2006 so overall revenues will be \$86 million below the August Consensus. SAF revenue is forecast to be \$11,221.3 million, representing 3.0 percent SAF baseline growth and 2.9 percent growth after tax adjustments. The FY 2006 SAF estimate is \$14.8 million lower than the August Consensus estimate (See Table 3).

Table 3
FY 2005-06 Administration Revenue Estimates
(millions)

	Consensus August 17, 2005		Administration January 12, 2006		Change
	Amount	Growth	Amount	Growth	
General Fund - General Purpose					
Baseline Revenue			\$8,235.0	2.5%	
Tax Cut Adjustments			(\$73.3)		
Net Resources	\$8,143.6	1.5%	\$8,161.7	-1.4%	\$18.1
School Aid Fund					
Baseline Revenue			\$11,208.0	3.0%	
Tax Cut Adjustments			\$13.3		
Net Resources	\$11,236.1	3.7%	\$11,221.3	2.9%	(\$14.8)
Combined					
Baseline Revenue			\$19,443.0	2.8%	
Tax Cut Adjustments			(\$60.0)		
Net Resources	\$19,379.7	2.7%	\$19,383.0	1.0%	\$3.3

Prepared By: Economic and Revenue Forecasting Division, Michigan Department of Treasury

FY 2007 Revenue Outlook

FY 2007 GF-GP revenue is expected to be \$8,428.2 million, a 3.3 percent baseline increase, and also a 3.3 percent increase after tax adjustments. The FY 2007 revenue total includes \$115 million in newly enacted SBT cuts. SAF revenue is forecast to be \$11,642.3 million, representing 3.7 percent SAF baseline growth and 3.8 percent growth after tax adjustments (see Table 4).

Table 4
FY 2006-07 Administration Revenue Estimates
(millions)

	Administration January 12, 2006	
	Amount	Growth
General Fund - General Purpose		
Baseline Revenue	\$8,510.4	3.3%
Tax Cut Adjustments	(\$82.1)	
Net Resources	\$8,428.2	3.3%
School Aid Fund		
Baseline Revenue	\$11,628.2	3.7%
Tax Cut Adjustments	\$14.0	
Net Resources	\$11,642.3	3.8%
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Combined		
Baseline Revenue	\$20,138.6	3.6%
Tax Cut Adjustments	(\$68.1)	
Net Resources	\$20,070.5	3.5%

Prepared By: Economic and Revenue Forecasting Division, Michigan Department of Treasury

Constitutional Revenue Limit

Article IX, Section 26, of the Michigan Constitution establishes a limit on the amount of revenue State government can collect in any given fiscal year. The revenue limit for a given fiscal year is equal to 9.49 percent of the State's personal income for the calendar year prior to the year in which the fiscal year begins. FY 2004 revenue is compared to CY 2002 personal income. If revenues exceed the limit by less than 1 percent, the State may deposit the excess into the Budget Stabilization Fund (BSF). If the revenues exceed the limit by more than 1 percent, the excess revenue is refunded to taxpayers via the income and single business taxes.

FY 2004 revenues were \$4.4 billion below the revenue limit, while FY 2005 revenues are expected to be \$4.8 billion below the limit. State revenues will also be well below the limit for FY 2006 and FY 2007. FY 2006 revenues are expected to be \$5.4 billion below the limit, and FY 2007 revenues \$5.5 billion below the limit (See Table 5).

Table 5
Administration Constitutional Revenue Limit Calculation
(millions)

	<u>FY 2004</u>	<u>FY 2005</u>	<u>FY 2006</u>	<u>FY 2007</u>
	<u>Actual</u>	<u>Admin</u>	<u>Admin</u>	<u>Admin</u>
	<u>May 2005</u>	<u>Jan 2006</u>	<u>Jan 2006</u>	<u>Jan 2006</u>
Revenue Subject to Limit	\$24,384.7	\$25,007.6	\$25,395.6	\$26,337.4
<u>Revenue Limit</u>	<u>CY 2002</u>	<u>CY 2003</u>	<u>CY 2004</u>	<u>CY 2005</u>
Personal Income	\$303,745	\$314,460	\$324,134	\$335,155
Ratio	9.49%	9.49%	9.49%	9.49%
Revenue Limit	\$28,825.4	\$29,842.2	\$30,760.3	\$31,806.2
<u>Amount Under (Over) Limit</u>	\$4,440.7	\$4,834.6	\$5,364.7	\$5,468.8

Budget Stabilization Fund Calculation

The Management and Budget Act contains provisions for calculating a recommended deposit or withdrawal from the BSF. The calculation looks at personal income net of transfer payments. The net personal income figure is adjusted for inflation. The change in this figure for the calendar year determines whether a pay-in or pay-out is dictated. If the formula calls for a deposit into the BSF, the deposit is made in the next fiscal year. If the formula calls for a withdrawal, the withdrawal is made during the current fiscal year.

If real personal income grows by more than 2 percent in a given calendar year, the fraction of income growth over 2 percent is multiplied by the current fiscal year's GF-GP revenue to determine the pay-in for the next fiscal year. If real personal income declines, the percentage deficiency under zero is multiplied by the current fiscal year's GF-GP revenue to determine the

withdrawal available for the current fiscal year. If the change in real personal income is between 0 and 2 percent, no pay-in or withdrawal is indicated.

Real calendar year personal income for Michigan is expected to increase by 1.2 percent in 2006. Therefore, the formula has no pay-in or withdrawal for FY 2006 (See Table 6).

Table 6
Budget and Economic Stabilization Fund Calculation
Based on CY 2006 Personal Income Growth
Administration Calculation

	CY 2005	CY 2006
Michigan Personal Income	\$ 335,155 ⁽¹⁾	\$ 351,242 ⁽¹⁾
less Transfer Payments	\$ 51,360 ⁽¹⁾	\$ 55,422 ⁽¹⁾
Income Net of Transfers	\$ 283,795	\$ 295,820
Detroit CPI	1.878 ⁽²⁾	1.935 ⁽³⁾
for 12 months ending	(June 2005)	(June 2006)
Real Adjusted Michigan Personal Income	\$ 151,116	\$ 152,879
Change in Real Adjusted Personal Income		1.2%
Between 0 and 2%		0.0%
GF-GP Revenue Fiscal Year 2005-2006		\$ 8,161.7
BSF Pay-In Calculated for FY 2007		FY 2006-2007
		NO PAY-IN INDICATED

Notes:

⁽¹⁾ Personal Income and Transfer Payments, Administration Forecast, January 2006.

⁽²⁾ Detroit Consumer Price Index, Average of 6 monthly values reported by BLS for each 12-month period.

⁽³⁾ Detroit Consumer Price Index, Administration Forecast, January 2006.

School Aid Fund Revenue Adjustment Factor

The School Aid Fund (SAF) revenue adjustment factor for the next fiscal year is calculated by dividing the sum of current year and subsequent year SAF revenue by the sum of current year and prior year SAF revenue. For example, the FY 2007 SAF revenue adjustment factor is calculated by dividing the sum of FY 2006 and FY 2007 SAF revenue by the sum of FY 2005 and FY 2006 SAF revenue. The SAF revenue totals are adjusted for any change in the rate and base of the SAF taxes. The year for which the adjustment factor is being calculated is used as the base year for any tax adjustments. For FY 2007, the SAF revenue adjustment factor is calculated to be 1.0338 (See Table 7).

Table 7
Administration School Aid Revenue Adjustment Factor
For Fiscal Year FY 2007

	<u>FY 2005</u>	<u>FY 2006</u>	<u>FY 2007</u>
Baseline SAF Revenue	\$10,881.7	\$11,208.0	\$11,628.2
Balance Sheet Adjustments	<u>\$28.0</u>	<u>\$13.3</u>	<u>\$14.0</u>
Net SAF Estimates	\$10,909.7	\$11,221.3	\$11,642.3
Adjustments to FY 2007 Base Year	<u>(\$13.9)</u>	<u>\$0.7</u>	<u>\$0.0</u>
Baseline Revenue on a FY 2006 Base	\$10,895.7	\$11,222.0	\$11,642.3

School Aid Fund Revenue Adjustment Calculation for FY 2007

Sum of FY 2005 & FY 2006	\$10,895.7	+	\$11,222.0	=	\$22,117.8
Sum of FY 2006 & FY 2007	\$11,222.0	+	\$11,642.3	=	\$22,864.3

FY 2007 Revenue Adjustment Factor	1.0338
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Note: Factor is calculated off a FY 2007 base year.

Revenue Detail

The estimated tax and revenue totals include the effects of all enacted tax changes except sales tax savings resulting from reductions in revenue sharing payments to local units. The revenue totals by tax are presented separately for GF-GP and for the SAF (See Tables 8 and 9). Tax totals for the income, sales, use, and tobacco taxes for all funds are also included (See Table 10).

Table 8
Administration General Fund General Purpose Revenue Detail
(millions)

	FY 2005		FY 2006		FY 2007	
	Amount	Growth	Amount	Growth	Amount	Growth
GF-GP Tax Amounts						
Income Tax	\$4,121.1	3.6%	\$4,164.3	1.0%	\$4,285.7	2.9%
Sales	\$99.2	-2.9%	\$102.3	3.1%	\$117.0	14.4%
Use	\$934.7	6.5%	\$963.9	3.1%	\$1,000.6	3.8%
Cigarette	\$116.5	-52.0%	\$231.3	98.5%	\$227.3	-1.7%
Beer & Wine	\$51.0	-1.0%	\$52.5	2.9%	\$52.5	0.0%
Liquor Specific	\$33.6	1.8%	\$34.0	1.2%	\$34.5	1.5%
Single Business Tax	\$1,913.5	4.7%	\$1,784.3	-6.8%	\$1,867.9	4.7%
Insurance Co. Premium	\$249.5	8.3%	\$250.0	0.2%	\$264.0	5.6%
Telephone & Telegraph	\$99.1	-2.2%	\$82.0	-17.3%	\$78.0	-4.9%
Inheritance Estate	\$101.5	34.4%	\$3.0	-97.0%	\$0.0	-100.0%
Intangibles	\$0.0	0.0%	\$0.0	0.0%	\$0.0	0.0%
Casino Wagering	\$42.2	1218.0%	\$43.1	2.2%	\$42.8	-0.7%
Horse Racing	\$0.0	0.0%	\$0.0	0.0%	\$0.0	0.0%
Oil & Gas Severance	\$66.7	16.8%	\$80.0	19.9%	\$70.0	-12.5%
GF-GP Other Taxes	\$52.5	118.8%	\$49.0	-6.7%	\$54.2	10.6%
Total GF-GP Taxes	\$7,881.0	3.6%	\$7,839.5	-0.5%	\$8,094.5	3.3%
GF-GP Non-Tax Revenue						
Federal Aid	\$35.7	-46.0%	\$35.0	-2.0%	\$35.0	0.0%
From Local Agencies	\$0.3	-89.7%	\$0.5	66.7%	\$0.5	0.0%
From Services	\$19.8	11.2%	\$18.0	-9.1%	\$18.0	0.0%
From Licenses & Permit	\$27.4	-50.4%	\$30.0	9.5%	\$30.0	0.0%
Miscellaneous	\$136.7	79.6%	\$144.1	5.4%	\$152.7	6.0%
Short Term Note Int.	\$0.0	0.0%	\$0.0	0.0%	\$0.0	0.0%
Interfund Interest	(\$74.4)	235.1%	(\$95.0)	27.7%	(\$95.0)	0.0%
Liquor Purchase	\$142.2	2.0%	\$140.0	-1.5%	\$143.0	2.1%
Charitable Games	\$11.7	-4.1%	\$11.7	0.0%	\$11.7	0.0%
Transfer From Escheats	\$100.0	12.4%	\$37.8	-62.2%	\$37.8	0.0%
Other Non Tax	\$0.0	0.0%	\$0.0	0.0%	\$0.0	0.0%
Total Non Tax	\$399.4	-8.5%	\$322.1	-19.4%	\$333.7	3.6%
Total GF-GP Revenue	\$8,280.5	3.0%	\$8,161.7	-1.4%	\$8,428.2	3.3%

Table 9
Administration School Aid Fund Revenue Detail

	FY 2005		FY 2006		FY 2007	
	Amount	Growth	Amount	Growth	Amount	Growth
School Aid Fund						
Income Tax	\$1,985.6	4.9%	\$2,057.3	3.6%	\$2,132.5	3.7%
Sales Tax	\$4,805.7	1.9%	\$4,944.5	2.9%	\$5,141.9	4.0%
Use Tax	\$467.6	6.5%	\$481.9	3.1%	\$500.3	3.8%
Liquor Excise Tax	\$33.1	2.2%	\$34.0	2.7%	\$34.5	1.5%
Cigarette	\$472.7	0.3%	\$469.8	-0.6%	\$460.7	-1.9%
Other Tobacco	\$0.0	0.0%	\$0.0	0.0%	\$0.0	0.0%
State Ed Prop Tax	\$1,914.5	4.9%	\$1,997.4	4.3%	\$2,112.4	5.8%
Real Estate Transfer	\$313.5	-1.3%	\$316.0	0.8%	\$328.0	3.8%
Ind and Comm Facilities	\$138.2	-8.0%	\$138.0	-0.1%	\$143.0	3.6%
Casino (45% of 18%)	\$97.6	1.9%	\$99.7	2.2%	\$99.0	-0.7%
Commercial Forest	\$3.1	10.7%	\$2.8	-9.7%	\$2.8	0.0%
Other Spec Taxes	\$10.5	-19.2%	\$12.0	14.3%	\$12.0	0.0%
Subtotal Taxes	\$10,242.1	2.7%	\$10,553.6	3.0%	\$10,967.1	3.9%
Lottery Transfer	\$667.6	3.5%	\$667.8	0.0%	\$675.2	1.1%
Total SAF Revenue	\$10,909.7	2.8%	\$11,221.3	2.9%	\$11,642.3	3.8%

Table 10
Administration Major Tax Totals

Major Tax Totals (Includes all Funds)						
Income Tax	\$6,108.2	4.0%	\$6,223.1	1.9%	\$6,419.7	3.2%
Sales Tax	\$6,599.1	1.9%	\$6,790.6	2.9%	\$7,060.9	4.0%
Use Tax	\$1,402.3	6.5%	\$1,445.8	3.1%	\$1,500.9	3.8%
Cigarette and Tobacco	\$1,179.9	18.8%	\$1,161.5	-1.6%	\$1,141.0	-1.8%